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SUBJECT: LATVIAN ECONOMY: BAD TO WORSE

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¶1. Summary: Latvia's economic downturn has proved to be worse than expected. Falling household purchasing power, induced by rising unemployment and real wage cuts, is significantly reducing domestic demand. Falling consumption is having a negative effect on tax revenues, which despite higher VAT rates continues to fall substantially below needed levels. Revenue shortfalls and the deficit limit requirements of recent IMF-EU financial assistance packages are pressuring the government to make additional budget cuts. Experts are predicting no economic turnaround until the end of 2010 or even 2011. The only bright spots are that relatively strong export growth and plunging imports helped slash Latvia's current account deficit from 26% of GDP to 12%, and inflation fell to single digits (9.8%) for the first time since July 2007. End summary.

Bleak Statistics

¶2. According to a Latvian Statistics Bureau flash estimate, the Latvian economy contracted by a massive 10.5% in the fourth quarter, which exceeded even the bleakest expectations. Third quarter data reveals that the principal sectors pulling the Latvian economy down (i.e. where growth is negative) are accommodation and food services (-11.4%), finance (-10.9%), manufacturing (-8.9%), retail and wholesale trade (-8.6%), and construction (-7.4%).

Tourism Woes

¶3. The decline in the accommodation and food service industry, already hit from weakening global tourism, may worsen even further due to tax increases that lifted the applicable VAT for hotels from 5% to 21%. This increase will damage Latvia's appeal as a tourism destination relative to other Baltic and Scandinavian countries. The hotel industry already served 9% less customers in the fourth quarter of 2008 than a year earlier, and hotel room occupancy rates fell to a mere 28.8% in December. In total, the contribution to the GDP from accommodation services fell by 11.4% in the third quarter.

Bank Profits Down

¶4. Latvian banks posted a 79% decline in profits for 2008. The financial sector has been hit hard by the global liquidity squeeze, the bust of Latvian property and lending bubbles, and increasing rates of bad loans. The quality of the banks' credit portfolios have deteriorated significantly. The proportion of loans with overdue payments reached 15% by the end of 2008, and this percentage will likely increase in 2009. A recent study carried out by a local bank found that 49% of households are struggling to meet mortgage payments.

Manufacturing and Retail Sales Hit

¶5. Manufacturing has suffered from diminishing competitiveness,

weakening global demand, and falling commodity prices in key industries such as wood, causing manufacturing output to plummet to levels only comparable to the Russian crisis of 1998. Latvian manufacturing output contracted by 18.2% in December. Exports of wood products decreased by 20% in 2008, and the wood industry's contribution to GDP fell by 15% in the third quarter. Figures for the last three months of the year will likely be even worse, as several additional wood product manufacturers went out of business or scaled back production. Another industry in the manufacturing sector that experienced a significant drop (-11%) in output was non-metallic mineral products. The poor performance of this industry is not unexpected, since its products (clay, glass, and concrete) are related to construction - which has come to a near standstill in Latvia.

¶6. Retail sales growth has been consistently falling since late 2007, reaching a record low of -19.8%, year on year, in January 2009. Categories experiencing the biggest sales drop are luxury items, home decor, and domestic appliances and electronics. While declines in luxury and electronic goods signal normalization of the reckless consumption which was greatly responsible for the overheated, pre-2008 Latvian economy, the decreased spending takes a significant toll on economic growth. Of all retail categories, dwindling motor vehicle sales took the largest toll on GDP growth, as the portion of GDP related to car sales decreased by 27%. According to industry statistics, the new car market in Latvia has shrunk by roughly 75%. Low consumer confidence will continue to negatively affect sales and lead Latvians to further postpone large purchases.

Construction Boom Over

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¶7. The construction sector's downturn is mostly due to the near freeze in new residential construction. Residential property construction's share of GDP fell by 33% in the third quarter. Tighter and more expensive credit, significant loss of household purchasing power, and low economic expectations deter people from investing in new property. Worries about the stability of the Lat add to the hesitation to invest. The most common currency for consumer loans continues to be the Euro, not only as banks protect themselves from currency exchange risks, but also due to the fact that loans in Lats are presently extremely expensive. As the market declines, property developers stuck with empty or uncompleted housing projects are filing for insolvency. In fact, property developers and construction companies constitute the majority of insolvency or bankruptcy protection applicants.

Positive Notes - Inflation and Current Account Deficit Down

¶8. Price and wage inflation have deteriorated Latvia's economic competitiveness during recent years. Latvia's short-term competitiveness has also been affected by currency depreciations in nearby countries. Despite these factors, Latvia's export growth remained fairly strong through most of 2008. In the last three months of 2008, however, export volume began shrinking, with tightening credit worsening the business environment. Andris Rozentals, the Vice President of the Commercial Banking Association, told us that banks are reluctant to lend both for the increased risks associated with the instability in the market and due to liquidity problems arising from the necessity to increase reserves for bad loans. Added to this, some banks face the potential of unplanned syndicated loan repayment calls. Combined with falling foreign investment and weak global demand, Latvian export businesses will mainly focus on maintaining their existing market share, not conquering new markets. Despite the harsh export environment, weakening local demand is causing imports to decline faster than exports, and the relative strengthening of exports has help Latvia start to close its once-ominous current account gap. The current account deficit already decreased to 12.6% of GDP in the third quarter of 2008, down from a high of 26%.

¶9. The latest data on employee compensation show that wage growth

has significantly slowed, and in the private sector has even turned negative. Compared to the third quarter of 2008, the average monthly gross nominal salary in the private sector fell by 0.5% in the fourth quarter. Salary reductions, coupled with tax increases and lower government spending, has already started to cause some societal unrest, but if this trend persists it will aid in restoring Latvia's economic competitiveness.

Comment

10. Press and government alike predict no short-term improvements in the Latvian economy. While the public is braced for needed fiscal tightening, the lack of foreseeable positive results will likely strain that public support. Despite tax rate increases, tax revenues in the first eight weeks of this year are down 16.2% compared to the same period last year, which makes many Latvians wonder what good the unpopular VAT increases serve. There is also frustration over the second round of budget cuts needed to comply with IMF and EU assistance conditions. On top of the previous 15% budget cuts, due to GDP contraction being more than double what was projected, another 15% cut is being contemplated. This latest round of budget measures will affect a wider spectrum of the public, surely adding to the ranks of discontented. The new PM-designate has promised that Latvia will meet the obligations of its IMF-EU aid packages, and no opposition parties are offering a "Plan B", but maintaining a stiff upper lip for two to three years to come may be difficult for even the hardest of Latvians.

Rogers